

# MONTANA STATE FUND

## 2004 ANNUAL REPORT



## Statutory Financial Statements



# 2004 ANNUAL REPORT

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# 2004 ANNUAL REPORT

## STATUTORY STATEMENTS OF ADMITTED ASSETS, LIABILITIES AND SURPLUS As of June 30,

### ADMITTED ASSETS

	<u>2004</u>	<u>2003</u>
<b>INVESTMENTS</b>		
Bonds	\$ 499,090,381	\$ 436,818,298
Equity Securities	72,138,374	69,958,153
Cash and Short-Term Investments	20,685,046	32,150,786
Other Investments - Collateral Securities on Loan	141,060,425	30,968,721
Total Investments and Cash	<u>732,974,226</u>	<u>569,895,958</u>
<b>OTHER ADMITTED ASSETS</b>		
Premium Receivables	7,818,889	7,354,843
Equipment (net)	962,632	815,820
Interest Receivable	7,520,657	6,586,054
Other Assets	532,037	186,713
Total Admitted Assets	<u>\$ 749,808,441</u>	<u>\$ 584,839,388</u>

### LIABILITIES AND SURPLUS

<b>LIABILITIES</b>		
Losses Incurred Reserves	\$ 410,090,000	\$ 372,300,000
Loss Adjustment Expense Reserves	42,025,000	41,100,000
Liability for Securities on Loan	141,060,425	30,968,721
Deferred Revenue	5,977,233	202,912
Other Liabilities	23,163,627	18,668,338
Total Liabilities	<u>622,316,285</u>	<u>463,239,971</u>

### CONTINGENCIES AND SUBSEQUENT EVENTS

<b>SURPLUS</b>		
Policyholders' Surplus	127,492,156	121,599,417
Total Liabilities and Surplus	<u>\$ 749,808,441</u>	<u>\$ 584,839,388</u>

The accompanying notes are an integral part of these financial statements.



# 2004 ANNUAL REPORT

## STATUTORY STATEMENTS OF REVENUE AND EXPENSES AND CHANGES IN SURPLUS For the Years Ended June 30,

	<u>2004</u>	<u>2003</u>
Net Premium Earned	\$139,360,612	\$117,776,580
Losses Incurred	(136,267,288)	(146,912,095)
Loss Expenses Incurred	(14,869,190)	(16,074,946)
Underwriting Expenses Incurred	<u>(20,841,166)</u>	<u>(17,559,701)</u>
Net Underwriting Loss	\$ (32,617,032)	\$ (62,770,162)
Net Investment Income Earned	26,562,859	26,799,946
Net Realized Capital Gains	1,103,132	2,126,151
Premium Balances Charged Off	(1,200,914)	(686,078)
Other Income (Expense)	<u>(202,031)</u>	<u>16,796</u>
Net Loss Before Dividends	(6,353,986)	(34,513,347)
Policyholder Dividends	<u>(1,909,856)</u>	<u>(2,949,597)</u>
Net Loss After Dividends	(8,263,842)	(37,462,944)
Prior Year End Surplus	121,599,417	158,498,995
Net Unrealized Gains on Equity Securities	12,773,545	777,514
Change in Nonadmitted Assets	1,403,739	(156,802)
Aggregate Write In for Other Losses in Surplus	(10,485)	(56,058)
Transfer Out	<u>(10,218)</u>	<u>(1,288)</u>
END OF PERIOD SURPLUS	<u>\$127,492,156</u>	<u>\$121,599,417</u>

The accompanying notes are an integral part of these financial statements.



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## STATUTORY STATEMENTS OF CASH FLOWS For the Years Ended June 30,

	2004	2003
<b>CASH FLOWS FROM OPERATIONS</b>		
Premiums Collected Net of Reinsurance	<b>\$146,927,098</b>	\$120,660,576
Loss and Loss Adjustment Expenses Paid	<b>(112,421,478)</b>	(95,987,041)
Underwriting Expenses Paid	<b>(21,108,225)</b>	(16,561,430)
Cash Provided by Underwriting	<b>13,397,395</b>	8,112,105
Net Investment Income	<b>27,338,864</b>	29,055,225
Other Income (Expenses):		
Agents' Balances Charged Off	<b>(1,200,914)</b>	(686,078)
Net Funds Held Under Reinsurance Treaties	<b>-</b>	(36,000)
Net Amount Withheld or Retained for Account of Others	<b>4,015,088</b>	4,207,231
Miscellaneous Income (Expense)	<b>-</b>	(4,272)
Cash Used for Other Income (Expense)	<b>2,814,174</b>	3,480,881
Dividends to Policyholders	<b>(1,909,856)</b>	(2,949,597)
<b>Net Cash Provided by Operations</b>	<b>41,640,577</b>	37,698,614
<b>CASH FLOWS FROM INVESTMENTS</b>		
Proceeds from Investments Sold, Matured or Repaid:		
Bonds	<b>86,563,955</b>	104,583,815
Collateral and Equity Securities	<b>10,593,324</b>	-
Total Investment Proceeds	<b>97,157,279</b>	104,583,815
Cost of Investments Acquired (long-term only):		
Bonds	<b>(148,909,900)</b>	(126,624,440)
Collateral and Equity Securities	<b>(148,909,900)</b>	(5,000,000)
Cost of Investment Acquired	<b>(148,909,900)</b>	(131,624,440)
<b>Net Cash Used For Investments</b>	<b>(51,752,621)</b>	(27,040,625)
<b>CASH FLOWS FROM FINANCING AND MISCELLANEOUS SOURCES</b>		
Cash Provided or (Applied):		
Transfers from Affiliates	<b>(10,218)</b>	(818)
Purchases of Equipment	<b>(1,333,335)</b>	(551,401)
Other Applications	<b>(10,143)</b>	10,143
<b>Net Cash Used for Financing and Miscellaneous Sources</b>	<b>(1,353,696)</b>	(542,076)
<b>NET INCREASE (DECREASE) IN CASH AND SHORT TERM INVESTMENTS</b>	<b>(11,465,740)</b>	10,115,913
<b>CASH AND SHORT TERM INVESTMENTS - BEGINNING OF YEAR</b>	<b>32,150,786</b>	22,034,873
<b>CASH AND SHORT TERM INVESTMENTS - END OF YEAR</b>	<b>\$ 20,685,046</b>	\$ 32,150,786

The accompanying notes are an integral part of these financial statements.



# 2004 ANNUAL REPORT

Notes to the Statutory Financial Statements  
June 30, 2004 and 2003

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## NOTE A - ORGANIZATION, BASIS OF PRESENTATION, AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

### 1. Organization

The Montana State Fund (MSF) is a nonprofit, quasi-public entity established under Title 39, Chapter 71 of the Montana Code Annotated (MCA). MSF provides Montana employers with an option for workers' compensation and occupational disease insurance and guarantees available coverage for all employers in Montana. MSF is governed by a seven member Board of Directors appointed by the Governor. MSF is a component unit of the State of Montana. MSF is attached to the State of Montana, Department of Administration for administrative purposes only. MSF governs, operates and completes its financial reporting as an insurance company domiciled in the State of Montana.

MSF functions as an autonomous insurance entity supported solely from its own revenues. All assets, debts, and obligations of MSF are separate and distinct from assets, debts, and obligations of the State of Montana. State law requires MSF to set premiums at least annually at a level sufficient to ensure adequate funding of the insurance program during the period the rates will be in effect. If MSF is dissolved by an act of law, the money in MSF is subject to the disposition provided by the legislature enacting the dissolution with due regard given to obligations incurred and existing (Section 39-71-2322, MCA).

During the 1990 Montana Special Legislative Session, legislation passed establishing separate funding and accounts for claims of injuries resulting from accidents occurring before July 1, 1990, referred to as the Old Fund, and claims occurring on or after July 1, 1990, referred to as the New Fund (MSF). This report reflects only the operations of the Montana State Fund (New Fund only). MSF administers and manages the remaining claims of the Old Fund on behalf of the State of Montana and receives an administrative fee.

State law required that any excess surplus in the Old Fund above an amount deemed as adequately funded by state law up to \$63.8M (million) be transferred to MSF. However, during the 2003 Montana Legislature, House Bill Number 363 (HB 363) was enacted and changes existing law regulating the Old Fund transfer of surplus. As a result of HB 363, any excess Old Fund surplus is to be transferred to the State of Montana General Fund rather than to MSF.

### 2. Basis of Presentation

The accompanying financial statements of MSF have been prepared in conformity with accounting practices prescribed and permitted by the State of Montana Department of Insurance. Such practices vary from accounting principles generally accepted in the United States of America (GAAP) principally in that certain assets reportable under GAAP are "nonadmitted" and have been excluded from the accompanying statutory statements of assets, liabilities and surplus and charged directly to net worth and that certain investments which would be carried at estimated fair value under GAAP are carried at amortized cost.



# 2004 ANNUAL REPORT

Notes to the Statutory Financial Statements  
June 30, 2004 and 2003

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## NOTE A - ORGANIZATION, BASIS OF PRESENTATION, AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, continued

### 2. Basis of Presentation, continued

The State of Montana Department of Insurance recognizes only statutory accounting practices prescribed or permitted by the State of Montana for determining and reporting the financial condition and results of operations of an insurance company. The National Association of Insurance Commissioners' (NAIC) *Accounting Practices and Procedures* manual, version effective January 1, 2001, (NAIC SAP) has been adopted as a component of prescribed or permitted practices by the State of Montana.

MSF's net income (loss) and surplus as stated on a NAIC SAP basis and on the basis of practices prescribed or permitted by the State of Montana are the same at June 30, 2004 and 2003.

The Montana Code Annotated references conformity with the Accounting Practices and Procedures Manual within section 33-2-701(1) and therefore concludes that no legislation is necessary to adopt its use.

### 3. Significant Accounting Policies

**Cash and Cash Equivalents** - Cash constitutes a medium of exchange that a bank or other similar financial institution will accept for deposit and allow an immediate credit to the depositor's account. Also classified as cash are savings accounts, certificates of deposits with maturity dates of one year or less, and cash equivalents. Cash equivalents are: investments with original maturities of three months or less; are readily convertible to known amounts of cash; and, present insignificant risk of change in value due to changes in interest rates. The Montana State Treasury holds MSF's cash and cash equivalent balances.

**Short-term Investments** - Short-term investments are those investments with remaining maturities of one year or less at the time of acquisition, excluding those investments classified as cash equivalents. Short-term investments include but are not limited to, bonds, commercial paper, money market instruments, repurchase agreements, and collateral and mortgage loans that meet the above criteria.

**Premium Receivable** - Premium receivable balances with an amount due over 90 days are nonadmitted assets. The MSF evaluates the remaining admitted accounts receivable asset for impairment. If it is probable that any amounts are not collectible, the uncollectible receivable is written off and charged to income in the period the determination is made.

**Risks and Uncertainties** - Risks and uncertainties existing as of the date of the financial statements, are as follows:

**Use of Estimates** - The preparation of financial statements in conformity with Statutory Accounting Principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the period. Actual results could differ from those estimates.



# 2004 ANNUAL REPORT

Notes to the Statutory Financial Statements  
June 30, 2004 and 2003

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## NOTE A - ORGANIZATION, BASIS OF PRESENTATION, AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, continued

### 3. Significant Accounting Policies, continued

#### Risks and Uncertainties, continued

Loss and LAE Reserves - Loss and loss adjustment expense (LAE) reserves are established to provide for the estimated ultimate settlement cost of all claims incurred. Management believes that the reserves for unpaid losses and loss adjustment expenses are adequate; however, there can be no assurance that the ultimate settlement of losses may not vary materially from the estimate recorded. Since liabilities are based on estimates, the ultimate liability may be in excess of, or less than, the amounts provided. Adjustment to these estimates of reserves will be reflected in the Statutory Statement of Revenue and Expenses in future years.

Uncertainty Due to Litigation - In the ordinary course of business, MSF is a defendant in various litigation matters. Although there can be no assurances, as of June 30, 2004 and 2003, in the opinion of MSF's management based on information currently available, the ultimate resolution of these legal proceedings would not be likely to have a material adverse effect on its statutory results of revenue and expenses, admitted assets, liabilities and surplus or liquidity. For further discussion, refer to Note J (Contingencies, Uncertainties and Subsequent Events).

Vulnerability Due to Certain Concentrations - MSF uses approximately 42 agencies located throughout Montana to market workers compensation policies with gross written premiums of \$94.5M for the year ended June 30, 2004. MSF conducts its business within the State of Montana for the most part and is susceptible to risk based on the economy of the geographic territory it serves.

**Administrative Cost Allocation** - State law requires MSF to separately determine and account for administrative expenses and benefit payments for claims for injuries resulting from accidents occurring before July 1, 1990 (Old Fund) from those occurring on or after July 1, 1990 (MSF). The law also limits annual administrative costs of claims associated with the Old Fund to \$1.25M for fiscal years 2004 and 2003, respectively. The Montana State Fund allocated \$1.25M in administration costs to the Old Fund in fiscal years 2004 and 2003, respectively. The Old Fund has a \$1.0M contingent obligation to the Montana State Fund in unrecovered administrative costs incurred in fiscal years prior to 2003 and 2004, which is not recorded in these financial statements. MSF intends to recover this amount in future years where the cost of administering the Old Fund is less than the statutorily permitted \$1.25M.

**Long-Term Securities** - Long-term securities consist of equity securities, bonds and certificates of deposit with original maturities greater than one year. Long-term securities are held by the Montana Board of Investments (BOI) and State Street Bank is the custodial bank for the BOI. Equity securities are valued at fair market value. Bonds are rated and valued in accordance with the Securities Valuation Office (SVO) rating guidelines. Bonds with a SVO rating of 1 and 2 are valued at amortized cost. Bonds with a SVO rating of 3 or higher are valued at the lower of cost or market. Bond amortization is calculated using the straight-line method.



# 2004 ANNUAL REPORT

Notes to the Statutory Financial Statements  
June 30, 2004 and 2003

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**NOTE A - ORGANIZATION, BASIS OF PRESENTATION, AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, continued****3. Significant Accounting Policies, continued**

**Long-Term Securities**, continued - In accordance with SSAP 26, bond amortization shall be calculated using the scientific (constant yield) interest method. MSF is not able to obtain this information from its fund manager at this time. Management believes the difference between the straight-line method and the scientific method is immaterial to the current year Statutory Statements of Revenue and Expenses and Changes in Surplus and is not able to determine the cumulative impact to the Statutory Statements of Admitted Assets, Liabilities and Surplus. MSF has no derivative investments.

**Electronic Computer Equipment and Software** - Electronic computer equipment is recorded at cost and depreciated on a straight-line basis over an estimated useful life of three years. Equipment is capitalized if the actual or estimated historical cost exceeds \$5,000. Software is amortized on a straight-line basis using a three-year life for operating software and a five year life for application software.

**Furniture, Equipment and Leasehold Improvements** - Furniture and equipment are recorded at cost and depreciated on a straight-line basis using estimated useful lives, which range from five to ten years. There are no leasehold improvements to property owned by the State of Montana and used by MSF requiring amortization. SSAP 16 requires that furniture, fixtures, equipment and leasehold/property improvements be capitalized, depreciated and nonadmitted.

**Losses Incurred and Loss Adjustment Expense Estimates** - Loss and loss adjustment expense (LAE) reserves are established to provide for the estimated ultimate settlement cost of all claims incurred. Loss reserves are based on reported aggregate claim cost estimates combined with estimates for future development of such claim costs and estimates of incurred but not reported (IBNR) claims. Tillinghast-Towers Perrin, an external actuarial firm, prepares an actuarial study used to estimate liabilities and the ultimate cost of settling claims reported but not settled and IBNR as of June 30, 2004 and 2003. The study provides a range of potential cost associated with the reported claims, the future development of those claims and IBNR. MSF management has selected the best estimates within that range as the estimated loss reserves. Because actual claim costs depend on such complex factors as inflation and changes in the law, claim liabilities are recomputed periodically using a variety of actuarial and statistical techniques to produce current estimates that reflect recent settlements, claim frequency, and other economic and social factors.

A provision for inflation and the calculation of estimated future claim costs is implicit in the calculation because reliance is placed both on actual historical data that reflect past inflation and on other factors that are considered to be appropriate modifiers of past experience. As of June 30, 2004 and 2003, \$452.1M and \$413.4M, respectively, of unpaid claims and claim adjustment expenses are presented at face value net of estimated reinsurance recoverable.

**Reinsurance Recoverables on Paid and Unpaid Losses** - Reinsurance recoverables are estimates of paid and unpaid losses collectible from MSF's reinsurers. The amounts ultimately collected may be more or less than these estimates. Any adjustments of these estimates are reflected in income, as they are determined.



# 2004 ANNUAL REPORT

Notes to the Statutory Financial Statements  
June 30, 2004 and 2003

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**NOTE A - ORGANIZATION, BASIS OF PRESENTATION, AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, continued****3. Significant Accounting Policies, continued**

**Deferred Revenue** - Deferred revenue reflects amounts billed or received in advance, but not yet earned for policies effective July 1, 2004 and 2003, respectively.

**Other Liabilities consist of:**

- **Security Deposits** - Security deposits are monies held on behalf of certain insured's due to their loss ratios and payment histories as well as due to particular payment terms. In addition, funds withheld in accordance with the reinsurance contract are also included in this account.
- **Accounts Payable** - Accounts payable includes liabilities incurred on behalf of claimants, refunds due to policyholders and amounts due to vendors.
- **Compensated Absences** - MSF supports two leave programs, the State of Montana Leave Program and the MSF Personal Leave Program, implemented in January 2002. The State of Montana Leave Program covers all employees represented by the union. Union represented employees accumulate both annual leave and sick leave and MSF pays employees 100% of unused annual leave and 25% of unused sick leave upon termination. MSF also pays 100% of unused compensatory leave credits upon termination to nonexempt employees. MSF Personal Leave Program covers all non-union employees. Non-union employees accumulate personal leave and extended leave. MSF pays employees 100% of unused personal leave upon termination but extended leave has no cash value at the time of termination. MSF absorbs expenses for termination pay in its annual operational costs. MSF had a total leave accrued liability of \$1.7M and \$1.4M at June 30, 2004 and 2003, respectively.

**Income Taxes Payable** - MSF is a component unit of the State of Montana and is not subject to Federal or State premium or income tax.

**Premium Revenue** - Premiums are recognized as revenue on a pro-rata basis over the policy period, beginning on the effective date of the policy. MSF's Board of Directors approves premium rates annually.

Policyholders are contractually obligated to pay certain premiums to MSF in advance of the period in which the premiums are earned. Advance premiums are deferred until the effective date of the policy at which time they are recognized as revenue on a pro-rata basis over the term of the policy. Premium advances are refundable when the policyholder's coverage is canceled and MSF has credited all earned premiums.

Expenses incurred in connection with acquiring new insurance business, including such acquisition costs as sales commissions, are charged to operations as incurred.

**Policyholder Dividends** - The amount of dividends to be paid to policyholders is determined annually by MSF's Board of Directors. The aggregate amount of policyholders' dividends is related to the financial results for the year and to the appropriate level of statutory surplus to be retained by MSF.



# 2004 ANNUAL REPORT

Notes to the Statutory Financial Statements  
June 30, 2004 and 2003

## NOTE B - INVESTMENTS

The investments of MSF as of June 30, 2004 and 2003 are as follows:

	<b>June 30, 2004</b>	<b>Total Investment Holdings</b>	<b>Percentage</b>
Bonds:			
U.S. Government Issuer Obligations	\$182,136,355	24.8%	
U.S. Government Single Class Mortgage-Backed/ Asset-Backed Securities	\$ 8,658,861	1.2%	
Special Revenue and Special Assessment Obligations	34,562,064	4.7%	
Public Utilities	19,305,000	2.6%	
Industrial and Miscellaneous Unaffiliated Issuer Obligations	207,647,450	28.3%	
Industrial and Miscellaneous Other Multi-Class Commercial Mortgage-Backed/Asset-Backed Securities	<u>46,780,651</u>	<u>6.4%</u>	
Total Bonds	499,090,381	68.1%	
Unaffiliated Publicly Traded Equity Securities	72,138,374	9.8%	
Cash and Short-Term Investments	20,685,046	2.8%	
Other Invested Assets	<u>141,060,425</u>	<u>19.2%</u>	
Total Invested Assets	<u>\$732,974,226</u>	<u>100.0%</u>	
	<b>June 30, 2003</b>	<b>Total Investment Holdings</b>	<b>Percentage</b>
Bonds:			
U.S. Government Issuer Obligations	\$151,604,707	26.6%	
U.S. Government Single Class Mortgage-Backed/ Asset-Backed Securities	9,938,587	1.7%	
Special Revenue and Special Assessment Obligations	58,112,993	10.2%	
Public Utilities	19,575,476	3.4%	
Industrial and Miscellaneous Unaffiliated Issuer Obligations	156,320,425	27.5%	
Industrial and Miscellaneous Other Multi-Class Commercial Mortgage-Backed/Asset-Backed Securities	<u>41,266,110</u>	<u>7.3%</u>	
Total Bonds	436,818,298	76.7%	
Unaffiliated Publicly Traded Equity Securities	69,958,153	12.3%	
Cash and Short-Term Investments	32,150,786	5.6%	
Other Invested Assets	<u>30,968,721</u>	<u>5.4%</u>	
Total Invested Assets	<u>\$569,895,958</u>	<u>100.0%</u>	



# 2004 ANNUAL REPORT

Notes to the Statutory Financial Statements  
June 30, 2004 and 2003

## NOTE B - INVESTMENTS, continued

The amortized cost and market value of securities as of June 30, 2004 are as follows:

June 30, 2004	Amortized Cost	Gross Unrealized			Market Value
		Gain	Loss		
Bonds:					
U.S. Government Issuer Obligations	\$182,136,355	\$ 5,413,825	\$2,591,072		\$184,959,108
U.S. Gov. Single Class Mortgage-Backed/ Asset-Backed Securities	8,658,861		255,591		8,403,270
Special Revenue/Assessment Obligations	34,562,064	1,049,286	58,739		35,552,611
Public Utilities	19,305,000	1,331,931			20,636,931
Industrial and Miscellaneous Unaffiliated Issuer Obligations	207,647,450	7,384,002	1,928,625		213,102,827
Ind. And Misc. Commercial Unaffiliated Mortgage-Backed/Asset-Backed Securities	47,201,739	741,100	668,337		47,274,502
Subtotal	499,511,469	15,920,144	5,502,364		509,929,249
Bond Write Down due to SVO Rating	(421,088)				-
Total Bonds	<u>\$499,090,381</u>				<u>\$509,929,249</u>
Unaffiliated Publicly Traded Equity Securities	<u>\$ 68,406,676</u>	<u>\$ 3,731,698</u>	<u>\$ -</u>		<u>\$ 72,138,374</u>
June 30, 2003	Amortized Cost	Gross Unrealized			Market Value
		Gain	Loss		
Bonds:					
U.S. Government Issuer Obligations	\$151,604,707	\$13,548,818	\$ -		\$165,153,525
U.S. Gov. Single Class Mortgage-Backed/ Asset-Backed Securities	9,938,587	-	11,093		9,927,494
Special Revenue/Assessment Obligations	58,112,993	2,730,890	-		60,843,883
Public Utilities	19,575,476	2,079,898	-		21,655,374
Industrial and Miscellaneous Unaffiliated Issuer Obligations	156,320,425	15,382,992	-		171,703,417
Ind. And Misc. Commercial Unaffiliated Mortgage-Backed/Asset-Backed Securities	41,986,572	1,815,437	720,462		43,081,547
Subtotal	437,538,760	35,558,035	731,555		472,365,240
Bond Write Down due to SVO Rating	(720,462)				-
Total Bonds	<u>\$436,818,298</u>				<u>\$472,365,240</u>
Unaffiliated Publicly Traded Equity Securities	<u>\$ 79,000,000</u>	<u>\$ -</u>	<u>\$ 9,041,847</u>		<u>\$ 69,958,153</u>



# 2004 ANNUAL REPORT

Notes to the Statutory Financial Statements  
June 30, 2004 and 2003

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**NOTE B - INVESTMENTS**, continued

The amortized cost and estimated market value of MSF's fixed maturity securities as of June 30, 2004 and 2003, are shown below at contractual maturity. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

<b>June 30, 2004</b>	<b>Carrying Value</b>	<b>Market Value</b>
Due one year or less (excludes STIP)	\$ 26,365,447	\$ 26,844,182
Due after one year through five years	147,503,679	152,273,132
Due after five years through ten years	230,617,869	234,268,425
Due after ten years	<u>94,603,386</u>	<u>96,543,510</u>
<b>Totals</b>	<b>\$499,090,381</b>	<b>\$509,929,249</b>

<b>June 30, 2003</b>	<b>Carrying Value</b>	<b>Market Value</b>
Due one year or less (excludes STIP)	\$ 9,688,914	\$ 9,875,934
Due after one year through five years	134,969,918	148,798,953
Due after five years through ten years	175,587,858	191,300,916
Due after ten years	<u>116,571,608</u>	<u>122,389,437</u>
<b>Totals</b>	<b>\$436,818,298</b>	<b>\$472,365,240</b>

During fiscal year ending June 30, 2004 MSF realized gross gains from sales of securities of \$1.8M and gross realized losses of \$742K. During fiscal year ending June 30, 2003, MSF realized gross gains from sales of securities of \$3.1M and gross realized losses of \$986K.

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**NOTE C - CASH COLLATERAL AND LIABILITY FOR SECURITIES ON LOAN**

Under the provisions of state statutes, the Montana Board of Investments (BOI) has, by a Securities Lending Authorization Agreement, authorized the custodial bank, State Street Bank, to lend BOI's securities to broker-dealers and other entities with a simultaneous agreement to return the collateral for the same securities in the future. State Street Bank was appointed the BOI's custodial bank on December 1, 1993. During the period the securities are on loan, BOI receives a fee and the bank must initially receive collateral equal to 102% of the market value of the securities on loan and must maintain collateral equal to not less than 100% of the market value of the loaned security. BOI retains all rights of ownership during the loan period.

The cash collateral received on each loan was invested, together with the cash collateral of other qualified plan lenders, in a collective investment pool, the Securities Lending Quality Trust. The relationship between the average maturities of the investment pool and BOI's loans was affected by the maturities of the loans made by other plan entities that invested cash collateral in the collective investment pool, which BOI could not determine. On June 30, 2004 and June 30, 2003, BOI had no credit risk exposure to borrowers.



# 2004 ANNUAL REPORT

Notes to the Statutory Financial Statements  
June 30, 2004 and 2003

## NOTE C - CASH COLLATERAL AND LIABILITY FOR SECURITIES ON LOAN, continued

The following table presents the carrying and market values of the securities on loan and the total collateral held for fiscal years 2004 and 2003:

	Fiscal Year <u>2004</u>	Fiscal Year <u>2003</u>
Securities on Loan - Book Value	\$134,808,112	\$26,912,989
Securities on Loan - Market Value	\$137,258,780	\$30,180,923
Total Collateral Held	\$141,060,425	\$30,968,721

## NOTE D - SHORT-TERM INVESTMENTS

MSF participates in the Short-Term Investment Pool (STIP) maintained by BOI. STIP balances are highly liquid investments. There are no legal risks that BOI is aware of regarding STIP investments. The market value of STIP approximates cost.

The STIP investments' credit risk is measured by investment grade ratings given individual securities. BOI's policy requires that STIP investments have the highest rating in the short-term category by one and/or any Nationally Recognized Statistical Rating Organizations (NRSRO). The four NRSRO's include Standard and Poor's, Moody's Investors Service, Fitch, Inc. and Dominion Bond Rating Service Ltd.

## NOTE E - ELECTRONIC COMPUTER EQUIPMENT AND SOFTWARE

Electronic computer equipment is recorded at cost and depreciated on a straight-line basis over an estimated useful life of three years. Equipment is capitalized if the actual or estimated historical cost exceeds \$5K. Software is amortized on a straight-line basis using a three year life for operating software and a five year life for application software.

	<u>Equipment and Operating Software</u>	<u>Application Software</u>	<u>Total</u>
<u>Balances June 30, 2004</u>			
Assets	2,501,389	8,800,924	11,302,313
Accumulated Depreciation	1,538,757	7,658,905	9,197,662
Net Assets Nonadmitted	-0-	1,142,019	1,142,019
Net Assets Admitted	962,632	-0-	962,632
Depreciation Expense	445,989	1,144,444	1,590,433
<u>Balances June 30, 2003</u>			
Assets	2,276,039	8,297,736	10,573,775
Accumulated Depreciation	1,460,219	6,187,366	7,647,585
Net Assets Nonadmitted	-0-	2,110,370	2,110,370
Net Assets Admitted	815,820	-0-	815,820
Depreciation Expense	434,409	1,192,259	1,626,668



# 2004 ANNUAL REPORT

Notes to the Statutory Financial Statements  
June 30, 2004 and 2003

## NOTE E - ELECTRONIC COMPUTER EQUIPMENT AND SOFTWARE, continued

**Furniture and Equipment** - Furniture and equipment are recorded at cost and depreciated on a straight-line basis using estimated useful lives, which range from five to ten years.

SSAP 16 requires that furniture, fixtures and equipment be capitalized, depreciated and nonadmitted.

	<b>Furniture and Equipment</b>	
	<u>June 30, 2004</u>	<u>June 30, 2003</u>
Assets	634,120	694,066
Accumulated Depreciation	389,605	385,925
Net Assets Nonadmitted	244,515	308,141
Net Assets Admitted	-0-	-0-
Depreciation Expense	74,511	98,958

**Building** - The 1981 Legislature appropriated funds for the construction of the Workers' Compensation building. As of July 1, 1990, MSF transferred the value of the building from its records to the Department of Administration, which owns most other state buildings. Under the agreement, MSF pays all costs associated with the building, including utilities, property taxes, janitorial services, and maintenance.

**Nonadmitted Assets** - Certain assets designated as "nonadmitted" are excluded from the Statutory Statement of Admitted Assets. Liabilities and Surplus and the change in such assets are charged directly to unassigned surplus.

## NOTE F - LOSS AND LOSS ADJUSTMENT RESERVES

Loss and loss adjustment expense (LAE) reserves are established to provide for the estimated ultimate settlement cost of all claims incurred. Loss reserves are based on reported aggregate claim cost estimates combined with estimates for future development of such claim costs and estimates of incurred but not reported (IBNR) claims.

Tillinghast-Towers Perrin, an external actuarial firm, prepares an actuarial study used to estimate liabilities and the ultimate cost of settling claims reported but not settled and IBNR as of June 30, 2004 and 2003. The study provides a range of potential cost associated with the reported claims, the future development of those claims and IBNR. MSF management has selected the best estimates within that range as the estimated loss reserves. Because actual claim costs depend on such complex factors as inflation and changes in the law, claim liabilities are recomputed periodically using a variety of actuarial and statistical techniques to produce current estimates that reflect recent settlements, claim frequency, and other economic and social factors.

Management believes that the reserves for unpaid losses and loss adjustment expenses are adequate; however, there can be no assurance that the ultimate settlement of losses may not vary materially from the estimate recorded. Since liabilities are based on estimates, the ultimate liability may be in excess of, or less than, the amounts provided. Adjustment to these estimates of reserves will be reflected in the Statutory Statement of Operations in future years.



# 2004 ANNUAL REPORT

Notes to the Statutory Financial Statements  
June 30, 2004 and 2003

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**NOTE F - LOSS AND LOSS ADJUSTMENT RESERVES, continued**

The following analysis provides a reconciliation of the activity in the reserve for losses and loss adjustment expenses.

	<u>Years Ended June 30,</u>	
	<u>2004</u>	<u>2003</u>
At beginning of year:		
Net reserves for losses and loss expenses	\$ 413,400,000	\$ 346,400,000
Losses and loss expenses incurred:		
Current year	136,058,828	116,597,841
Prior years	<u>13,568,639</u>	<u>35,366,198</u>
Total	149,627,467	151,964,039
Losses and loss expenses paid:		
Current year	(34,574,875)	(22,981,961)
Prior years	<u>(76,337,592)</u>	<u>(61,982,078)</u>
Total	<u>(110,912,467)</u>	<u>(84,964,039)</u>
Total losses and loss adjustment expenses		
at end of the year	<u>\$ 452,115,000</u>	<u>\$ 413,400,000</u>

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**NOTE G - RETIREMENT PLANS, DEFERRED COMPENSATION AND POSTRETIREMENT PLANS**

MSF and its employees contribute to the Public Employees Retirement System (PERS), which offers two types of retirement plans administered by the Public Employees' Retirement Board (PERB). The first plan is the Defined Benefit Retirement Plan (DBRP), a multiple-employer, cost-sharing plan that provides retirement, disability and death benefits to plan members and their beneficiaries. Benefits are based on eligibility, years of service and highest average compensation. Vesting occurs once membership service totals five years. Benefits are established by state law and can only be amended by the legislature.

The second plan is the Defined Contribution Retirement Plan (DCRP), created by the 1999 legislature and available to all active PERS members effective July 1, 2002. This plan is a multiple-employer, cost-sharing plan that also provides retirement, disability and death benefits to plan members and their beneficiaries. Benefits are based on the balance in the member's account, which includes the total contributions made, the length of time the funds have remained in the plan and the investment earnings less administrative costs.

Eligible PERS members choose to participate in either the DBRP or DCRP but may not be active members of both plans. MSF and its employees are required to contribute 6.9% of annual compensation in fiscal years 2004 and 2003. MSF's contributions amounted to \$830K for fiscal year 2004 and \$711K for fiscal year 2003. MSF and its employees paid one hundred percent of required contributions to PERS and there is no unpaid liability as of June 30, 2004.



# 2004 ANNUAL REPORT

Notes to the Statutory Financial Statements  
June 30, 2004 and 2003

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## **NOTE G - RETIREMENT PLANS, DEFERRED COMPENSATION AND POSTRETIREMENT PLANS, continued**

MSF and its employees are eligible to participate in the State of Montana Deferred Compensation Plan (457 plan) administered by the PERB. The Deferred Compensation plan is a voluntary, tax-deferred retirement plan designed as a supplement to other retirement plans. Under the plan, eligible employees elect to defer a portion of their salary until future time periods. MSF incurs no costs for this plan.

## **NOTE H - POLICYHOLDERS' DIVIDENDS**

During fiscal year 2004 and 2003, the MSF's Board of Directors authorized a dividend to be paid to policyholders of record during policy years 2002 and 2001, respectively.

Payment of the dividend totaling \$1.9M was accomplished during May 2004 and the payment totaling \$2.9M was accomplished during May 2003.

## **NOTE I - REINSURANCE ASSUMED AND CEDED**

For the fiscal years ended June 30, 2004 and June 30, 2003 MSF ceded reinsurance to other reinsurance companies to limit the exposure arising from large losses. These arrangements consist of excess of loss contracts that protect against occurrences over stipulated amounts and an aggregate stop loss contract. The excess of loss contracts provide coverage of \$95.0M for both fiscal years 2004 and 2003. During fiscal year 2004 and 2003 MSF retained the first \$5.0M for the first layer of reinsurance coverage. Individual, per person coverage was provided up to \$5.0M per any one individual loss for both fiscal years 2004 and 2003.

The term of the current aggregate stop loss contract is July 1, 2002 through June 30, 2005. The contract provides coverage based on MSF's premium levels at \$8.6M per year but not to exceed \$21.0M in the aggregate over three years. The previous aggregate stop loss contract was commuted prior to June 30, 2002. In the event reinsurers are unable to meet their obligations under either the excess of loss contracts or aggregate stop loss contract, MSF would remain liable for all losses, as the reinsurance agreements do not discharge MSF from its primary liability to the policyholders.

Premium revenue is reduced by premiums paid for reinsurance coverage of \$6.6M and \$5.7M in fiscal years 2004 and 2003, respectively. The aggregate stop loss contract requires that MSF maintain a funds withheld account which represents the basic premium portion of the total premium paid for aggregate stop loss coverage. The funds withheld account at June 30, 2004 is \$4.8M comprised of \$2.6M of basic premium for fiscal year 2004 and \$2.2M for fiscal year 2003. Interest must be accrued quarterly at an annual rate of 6.5% on the funds withheld account, resulting in accrued interest of \$326K for fiscal year 2004 and \$143K for fiscal year 2003.

During fiscal years 2004 and 2003, estimated claim reserves were reduced \$10.0M and \$8.0M respectively, for the amount of reinsurance estimated to be ultimately recoverable on incurred losses.

MSF also has assumed reinsurance relationships with Argonaut Insurance Company, Fireman's Fund Insurance Company and Legion Insurance Company related to Other States Coverage (OSC). MSF assumes risk for OSC claims, which are then covered under MSF's ceded reinsurance contract. Assumed premium for fiscal years 2004 and 2003 is \$2.0M and \$1.6M, respectively.



# 2004 ANNUAL REPORT

Notes to the Statutory Financial Statements  
June 30, 2004 and 2003

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## NOTE J - CONTINGENCIES, UNCERTAINTIES AND SUBSEQUENT EVENTS

### Contingencies

**Murer, et al v. Montana State Compensation Mutual Insurance Fund, et al.** WCC No. 9206-6487, involves the 1987 legislature's capping of workers' compensation benefits (\$299.00 a week for total benefits and \$149.50 a week for partial benefits) for injuries occurring during the period July 1, 1987 through June 30, 1989. The 1989 legislature reenacted those caps for the period July 1, 1989 through June 30, 1991 for injuries occurring between July 1, 1989 and June 30, 1991.

The Montana Supreme Court found that these caps should have expired on June 30, 1989 for injuries occurring between July 1, 1987 and June 30, 1989 and should have expired on June 30, 1991 for injuries occurring between July 1, 1989 and June 30, 1991.

As a result, the Montana State Fund, under Workers' Compensation Court direction, performed a review of approximately 7500 claims. Those claims qualifying are paid 85% of the increased rate, with 15% paid to the claimant attorney. Cost impact is estimated to be over \$1 million but with a cost no greater than \$2 million. The cost impact has been paid or is included in Montana State Fund's loss reserves. The review and payment process is near finalization, but ongoing.

**State Compensation Insurance Fund v. George Berg, et al.** Case No. DV-99-34 (Fergus County) is a pending suit against a former policyholder in which the Montana State Fund claims the policyholder failed to pay workers' compensation insurance premiums, plus interest on the unpaid premiums. The total claim was originally for \$1.0M, but on further evaluation has been reduced to approximately \$660K. Berg filed a counterclaim against the Montana State Fund on various claims, seeking unspecified damages. Montana State Fund does not think the counterclaim has merit, but there is a remote chance of an adverse judgment against the Montana State Fund. This matter was expected to go to trial sometime during 2001. However, Berg filed a Chapter 11 bankruptcy petition in Montana Bankruptcy Court, which stayed any further proceedings in the state court action. The Montana State Fund entered into a tentative settlement with Berg for payment of \$100K cash, plus \$125K payable over time. This settlement was subject to approval by the bankruptcy court in a Chapter 11 plan of reorganization. However, the bankruptcy court converted the case to a Chapter 7 liquidation. This had the effect of resurrecting the Montana State Fund's original claim amount of \$660K. The bankruptcy trustee is now liquidating Berg's bankruptcy estate. At this time, Montana State Fund is not certain how much of this claim will be recovered.

**Stavenjord v. State Compensation Insurance Fund.** The Workers' Compensation Court decided that the Stavenjord case should be applied retroactively but only to June 3, 1999. The court also held that a common fund does exist and that the claimant is entitled to common fund attorney fees with respect to post June 3, 1999 Stavenjord entitlements. The impact of the decision is determined to be \$2.1M and is reflected in the fiscal year 2004 Statement of Revenues, Expenses, and Changes in Net Assets. This decision has been appealed to the Montana Supreme Court.

The Stavenjord case was issued by the Workers' Compensation Court on May 22, 2001. It addressed the issue of whether the failure of the Occupational Disease Act (ODA) to provide PPD (permanent partial disability) benefits equivalent to the benefits provided in the Montana WCA (Workers Compensation Act) violates the claimant's right to equal protection of the law. Relying on the Henry case (previous case from the Supreme Court finding that vocational rehabilitation benefits must also be paid under the ODA), the court said it did, holding "Where PPD benefits calculated pursuant to the WCA are greater than the benefits available to a claimant under the ODA, constitutional equal protection guarantees require that benefits be computed and paid in accordance with the WCA. The claimant in this case is entitled to \$27K under the WCA, versus \$10K under the ODA." The case was affirmed by the Montana Supreme Court on April 1, 2003.



# 2004 ANNUAL REPORT

Notes to the Statutory Financial Statements  
June 30, 2004 and 2003

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## NOTE J - CONTINGENCIES, UNCERTAINTIES AND SUBSEQUENT EVENTS, continued

**Robert Flynn v. State Compensation Insurance Fund.** The Claimant, Robert Flynn, filed a petition in the Workers' Compensation Court for the State of Montana in which he alleged that the Respondent, State Compensation Insurance Fund, should pay a proportionate share of the attorney fees he incurred to recover social security disability benefits. Flynn also requested that the Court sanction the Montana State Fund for unreasonably reducing his temporary total disability benefits in an effort to recoup overpayments. The Workers' Compensation Court denied both of Flynn's claims and Flynn appealed. The Court affirmed in part and reversed in part the judgment of the Workers' Compensation Court. (1) The Court decided that pursuant to the common fund doctrine, the Montana State Fund should contribute, in proportion to the benefits it actually received, to the costs of the litigation, including reasonable attorney fees. The Workers' Compensation Court erred when it denied Flynn's request for reasonable apportionment of attorney fees. To the extent it declined to apply the common fund doctrine, the judgment of the Workers' Compensation Court was reversed by the Supreme Court. (2) The Supreme Court agreed that nothing in the record indicated that the Montana State Fund acted unreasonably in offsetting Flynn's benefits. Therefore, the Workers' Compensation Court did not err when it concluded that the Montana State Fund was entitled to reduce Flynn's disbursements to the extent that it did to recover overpaid benefits.

The matter is currently on remand, and the Workers' Compensation Court ruled on August 5, 2003 on the issues of whether a common fund had been established and whether the decision should be applied retroactively. The court ruled for the claimant on both issues as follows, "Since claimant's entitlement to attorney fees is a matter of law and arose only after the decision on appeal, the post-remand request for attorney fees is timely." Also, "Whether the blanket rule of retroactivity of judicial decisions adopted by the United States Supreme Court in Harper v. Virginia Dept. of Taxation, 509 U.S. 86 (1993), or the more flexible rule from Chevron Oil C. v. Huson, 404 U.S. 97 (1971), is applied, the decision in Flynn v. State Compensation Ins. Fund, 2002 MT 279, 312 Mont. 410, 60 P.3d 397, must be applied retroactively." Settlement discussions on implementation of the common fund have been initiated. As data is not fully compiled and reviewed, no analysis of cost estimates is available at this time; however, ultimate impact is estimated at less than \$1.0M.

**Schmill v. Liberty Northwest Insurance.** This case, 2003 MT 80, decided April 10, 2003 by the Montana Supreme Court held as follows, "We conclude that the ODA and the WCA treat similarly situated classes of workers differently. Furthermore, apportioning Schmill's permanent impairment award for her occupational disease pursuant to § 39-72-706, MCA, of the ODA while providing full benefits for injured workers pursuant to the WCA is not rationally related to a legitimate governmental interest. Therefore, we conclude that § 39-72-706, MCA, violates the equal protection guarantee found at Article II, Section 4 of the Montana Constitution. The judgment of the Workers' Compensation Court is affirmed." Retroactive application of the decision and its status as a common fund is presently before the Workers' Compensation Court in on-going litigation. The decision of the Workers' Compensation Court will likely be appealed to the Montana Supreme Court by at least one of the parties.

Should the ultimate decision of the Montana Supreme Court be to create a common fund and apply the decision retroactively, the cost is estimated at \$1.5 to \$2 million dollars. Should the ultimate decision of the Montana Supreme Court be to apply the decision retroactively, the impact on the Old Fund liability for claims that occurred before July 1, 1990 is estimated at \$800K. Final disposition is unknown at this time. This was not a case against the Montana State Fund, but the holding of this decision applies to Montana State Fund. Montana State Fund's motion to intervene in the case was granted by the Workers' Compensation Court. In addition a separate case against the Montana State Fund on this same issue has been filed in the Workers' Compensation Court as Montana State Fund v. Minnick.



# 2004 ANNUAL REPORT

Notes to the Statutory Financial Statements  
June 30, 2004 and 2003

## NOTE J - CONTINGENCIES, UNCERTAINTIES AND SUBSEQUENT EVENTS, continued

**Wild v. Fregein and Montana State Compensation Insurance Fund.** This case, 2003 MT 115, decided April 29, 2003, primarily held that § 39-71-401(3), MCA, does not, as a matter of law, conclusively preclude any factual inquiry into whether an employer/employee relationship exists once the worker has been issued the exemption contemplated by § 39-71-401(3), MCA.", and ... "that § 39-71-401(3), MCA, read in conjunction with § 39-71-120, MCA, does require the employer to make an initial good faith inquiry of the worker to determine that he or she does, in fact, meet the control and independently established business tests before the employer employs the worker as an IC and if the employer determines the worker is an IC, to thereafter treat the worker as an IC and not as an employee as Fregein treated Wild in this case." Retroactive application of the decision and its status as a common fund is presently before the Workers' Compensation Court in on-going litigation. As data on identification of potential claims is difficult to identify, no analysis of cost estimates on retroactive application of the decision is available at this time.

## NOTE K - RECLASSIFICATIONS

Certain amounts in the prior year financial statements have been reclassified for comparative purposes to conform with the presentation in the current year financial statements.

## NOTE L - UNASSIGNED SURPLUS - NONADMITTED ASSETS AND RECONCILIATION TO GAAP

	<u>Years Ended June 30</u>	
	<u>2004</u>	<u>2003</u>
<b>Balance of nonadmitted assets - beginning of year</b>	\$ 6,081,826	\$ 5,046,918
Cumulative nonadmitted DAC	-	878,106
Subtotal	<u>6,081,826</u>	5,925,024
Increase (decrease) in nonadmitted assets:		
Change in premiums receivable	(118,417)	769,828
Change in short-term notes and loans receivable	(56,496)	(24,458)
Change in bond downgrades	(299,374)	360,145
Change in net tangible assets	(63,626)	(40,060)
Change in intangible assets	(968,351)	(987,467)
Increase in other assets	<u>698,757</u>	<u>78,814</u>
Net increase (decrease) in nonadmitted assets	<u>(807,507)</u>	<u>156,802</u>
<b>Balance of nonadmitted assets - end of year</b>	<u>\$ 5,274,319</u>	<u>\$ 6,081,826</u>

The following schedule reconciles Statutory Surplus calculated in accordance with NAIC SAP to Net Assets as determined by generally accepted (governmental) accounting principles at June 30.

	<u>2004</u>	<u>2003</u>
Statutory Surplus (NAIC SAP)	\$127,492,456	\$121,599,417
Add:		
Nonadmitted assets as shown above	5,274,319	6,081,826
Change in investment value of bonds to fair market value	10,838,868	35,546,942
Less the portion of the change in investment		
value recognized for GAAP	(421,088)	(720,462)
The change in net income between NAIC SAP and GAAP for:		
Deferred acquisition costs	(412,079)	596,232
Reversal of small adjustment and other	(298)	(10,140)
Net assets (GAAP)	<u>\$142,772,178</u>	<u>\$163,093,815</u>



# 2004 ANNUAL REPORT

Notes to the Statutory Financial Statements  
June 30, 2004 and 2003

## NOTE M - SUPPLEMENTAL INVESTMENT RISK INFORMATION

MSF's largest ten exposures to a single issuer/borrower/investment, listed by investment category (excluding U.S. government-related securities) are:

<u>June 30, 2004</u>	<u>Amount</u>	<u>% of Total Admitted Assets</u>
Industrial & Misc. Other Multi-Class Comm. Mrtg./Asset-Backed Securities	\$ 13,912,902	1.856%
Industrial & Misc. Other Multi-Class Comm. Mrtg./Asset-Backed Securities	9,964,203	1.329%
Industrial & Misc. U.S. Unaffiliated Issuer Obligations	9,951,145	1.327%
Industrial & Misc. U.S. Unaffiliated Issuer Obligations	9,944,109	1.326%
Industrial & Misc. Other Multi-Class Comm. Mrtg./Asset-Backed Securities	9,193,094	1.226%
Industrial & Misc. U.S. Unaffiliated Issuer Obligations	7,758,301	1.035%
Public Utilities	5,999,308	0.800%
Industrial & Misc. U.S. Unaffiliated Issuer Obligations	5,302,878	0.707%
Industrial & Misc. U.S. Unaffiliated Issuer Obligations	5,178,631	0.691%
Industrial & Misc. U.S. Unaffiliated Issuer Obligations	5,138,182	0.685%

<u>June 30, 2003</u>	<u>Amount</u>	<u>% of Total Admitted Assets</u>
Industrial & Misc. Other Multi-Class Comm. Mrtg./Asset-Backed Securities	\$ 14,697,335	2.513%
Industrial & Misc. Other Multi-Class Comm. Mrtg./Asset-Backed Securities	9,959,721	1.703%
Industrial & Misc. U.S. Unaffiliated Issuer Obligations	8,152,315	1.394%
Public Utilities	5,996,554	1.025%
Industrial & Misc. U.S. Unaffiliated Issuer Obligations	5,344,042	0.914%
Industrial & Misc. U.S. Unaffiliated Issuer Obligations	5,244,872	0.897%
Industrial & Misc. U.S. Unaffiliated Issuer Obligations	5,181,005	0.886%
Industrial & Misc. U.S. Unaffiliated Issuer Obligations	5,168,927	0.884%
Industrial & Misc. U.S. Unaffiliated Issuer Obligations	5,036,880	0.861%
Industrial & Misc. U.S. Unaffiliated Issuer Obligations	5,031,611	0.860%

The amounts and percentages of MSF's total admitted assets held in bonds by NAIC rating are:

<u>June 30, 2004</u>	<u>Amount</u>	<u>% of Total Admitted Assets</u>
NAIC-1	\$419,336,456	55.926%
NAIC-2	76,352,228	10.183%
NAIC-3	<u>3,401,697</u>	<u>0.454%</u>
Total Bonds	<u>499,090,381</u>	<u>66.563%</u>

<u>June 30, 2003</u>	<u>Amount</u>	<u>% of Total Admitted Assets</u>
NAIC-1	\$348,516,479	59.592%
NAIC-2	80,969,218	13.845%
NAIC-3	<u>7,332,601</u>	<u>1.254%</u>
Total Bonds	<u>436,818,298</u>	<u>74.691%</u>



# 2004 ANNUAL REPORT



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## INDEPENDENT AUDITORS' REPORT

To the Audit Committee of the  
Board of Directors  
Montana State Fund  
Helena, Montana

We have audited the accompanying statutory statements of admitted assets, liabilities and surplus of Montana State Fund (MSF), a component unit of the State of Montana, at June 30, 2004 and 2003, and the related statutory statements of revenue and expenses, changes in surplus and cash flows for the years then ended. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform our audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described more fully in Note A to the financial statements, MSF prepared these financial statements in conformity with accounting practices prescribed or permitted by the Insurance Department of Montana, which practices differ from accounting principles generally accepted in the United States of America. The effects on the financial statements of the variances between statutory accounting practices and accounting principles generally accepted in the United States of America are described in Note L.

In our opinion, the financial statements referred to in the first paragraph present fairly, in all material respects, the admitted assets, liabilities, and surplus (statutory basis) of Montana State Fund for the years ended June 30, 2004 and 2003, and results of its operations, changes in surplus and cash flows (statutory basis) for the years ended June 30, 2004 and 2003 on the basis of accounting described in Note A.

However, because the company prepares its financial statements on a statutory basis of accounting, as discussed in the preceding paragraph, it is our opinion, that the financial statements referred to above do not present fairly, in conformity with accounting principles generally accepted in the United States of America, the financial position of Montana State Fund for the years ended June 30, 2004 and 2003 or the results of its revenue and expenses, changes in surplus and cash flows for the years then ended.

*Galuska, Higgins & Galuska, PC*

GALUSHA, HIGGINS AND GALUSHA, PC  
Certified Public Accountants and Advisors

Helena, Montana  
January 5, 2005

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# 2004 ANNUAL REPORT



December 16, 2004

To The Board of Directors of the Montana State Fund:

The Tillinghast business of Towers Perrin was engaged by the Montana State Fund (MSF) to estimate the unpaid loss and loss adjustment expenses as of June 30, 2004, for MSF's workers' compensation exposures. Our examination included the performance of independent projections of MSF's loss and loss expense liabilities and such other tests and procedures as we considered necessary in the circumstances. We relied on MSF personnel as to the completeness and accuracy of the data.

Our estimated loss and loss adjustment expense liability as of June 30, 2004, is \$443.7 million, undiscounted, and net of reinsurance recoverables. MSF has recorded a provision of \$452.1 million on its June 30, 2004 balance sheet for unpaid loss and loss adjustment expense.

In our opinion, the amounts recorded in the balance sheet as reserves for estimated loss and loss adjustment expense liabilities: (1) Are consistent with amounts calculated in accordance with commonly accepted actuarial methods and are fairly stated on an ultimate undiscounted basis in accordance with the *Statement of Principles Regarding Property and Casualty Loss and Loss Adjustment Expense Reserves* adopted by the Casualty Actuarial Society; (2) Are consistent with amounts based upon actuarial assumptions which are reasonable given the coverages provided; and (3) Make good and sufficient provision in the aggregate for all unpaid loss and loss adjustment expense obligations.

The Policyholders' Surplus of MSF as of June 30, 2004, is \$127.5 million, using statutory accounting principles. Current year premium revenue was \$139.4 million. We note that the Policyholders' Surplus level of MSF is consistent with traditional industry standards. We believe that it is prudent for MSF to set a long-term goal of maintaining appropriate surplus based on industry standards.

## VARIABILITY

Loss and loss adjustment expense reserve estimates are subject to considerable uncertainty due to the fact that the ultimate liability for claims is subject to the outcome of events yet to occur. In evaluating whether the reserves make a reasonable provision for unpaid losses and loss expenses, it is necessary to project future loss and loss adjustment expense payments. Actual future losses and loss adjustment expenses will not develop exactly as projected and may, in fact, vary significantly from the projections.

  
\_\_\_\_\_  
Robert F. Conger  
Fellow, Casualty Actuarial Society  
Member, American Academy of Actuaries



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